

EXAMINATION COVERAGE

The Internal Revenue Service examines returns to ensure that the proper tax has been reported. In deciding how to allocate its limited examination resources, the IRS attempts to maintain examination coverage rates that provide an adequate enforcement presence in the various market segments in order to decrease the tax gap and foster an increase in voluntary compliance.

The IRS' primary method of selecting returns for examination is the computer selection program known as Discriminant Function System (DIF). This computer scoring system evaluates every return filed and identifies those returns with the highest chance of needing correction. The IRS also addresses important compliance issues such as increased instances of nonfiling, questionable tax shelter activity, or tax refund fraud, and conducts local enforcement programs, through the use of special initiatives.

For example, in 1995 the IRS began an aggressive effort to combat refund fraud. This was in response to serious concerns raised by IRS, the Treasury Department and Congress that refund fraud could be costing American taxpayers as much as \$5 billion a year. In both 1995 and 1996, the IRS examined a number of returns, many of which claimed the Earned Income Tax Credit (EITC), to ensure that the refund was correct before it was issued.

Statistics on audit coverage rates -- audits as a percentage of returns filed -- in various income classes will, of course, reflect these special initiatives. For example, the focus on EITC returns resulted in an increase in the audit rates for returns filed by taxpayers reporting less than \$25,000 of income.

At the same time, the IRS also experienced an overall reduction in examination staff due to budget cuts and an increase in the number of nonbusiness returns filed by individuals reporting over \$100,000 of income. Together, these two facts lowered the audit coverage rate for these returns.

Without an understanding of these factors affecting the examination program, a merely statistical review of audit coverage in recent years could result in an erroneous conclusion that the IRS was unfairly targeting lower income taxpayers at the expense of higher income taxpayers.

(more)

The DIF formula used to select returns is a nationally developed formula and it is applied consistently in every state. Identical returns filed by different taxpayers in different states would receive the same score under the DIF system.

When the DIF formula is applied to all returns filed, IRS statistics show that some states have more returns, as a percentage of the returns filed, with a higher potential for error than other states. This return “fallout” is a major factor in allocating examination resources, since the IRS attempts to use its limited resources to audit those returns that are most in need of correction.

As one would expect, audit coverage rates differ among the states. There are several reasons for this. The most obvious is that compliance with the tax laws varies among states. Taxpayers and the returns they file are not homogeneous from state to state. To be fair and efficient, the IRS needs to audit those taxpayers most in need of auditing, and they are not uniformly distributed among every state. According to the most recent IRS compliance data, the overall accuracy of returns in states with higher audit coverage rates was significantly lower than the overall accuracy of returns in states with lower audit rates -- only 90.3% compared to 94.9%.

Differences in the kinds of returns filed from state to state also contribute to differences in audit coverage rates. For example, states with higher rates also have a much higher concentration of business returns -- 7.6% compared to 5.6%. Taxpayers tend to be less accurate in reporting business income -- typically due to the lack of third party information reporting -- than in reporting wages, interest, dividends and pension income. It should therefore be expected that states with a higher rate of business returns would also have a higher rate of audits.

The IRS subjects all returns to two other routine evaluations, regardless of where the taxpayer lives, ensuring consistent treatment of all taxpayers:

- First, every return is subjected to a “math error” check as it is processed. Not only are simple errors corrected by this process, but a number of items are disallowed or adjusted. For example, the EITC and self-employment tax amounts are adjusted to conform with other information reported on the return.
- Second, information on every return is matched against the information the IRS receives from third-party documentation, such as Forms W-2 and 1099, to identify potential underreporting. Mismatches are pursued by sending notices to the taxpayers without regard to the geographical distribution of these cases.

(more)

The following chart shows examination coverage for selected taxpayer groups during the last three fiscal years.

AUDIT COVERAGE

(Returns examined as a percent of total returns filed in that group)

Type of income tax return	FY-94	FY-95	FY-96
Individuals, by income:			
1040A, < \$25K	1.04	1.96	2.00
Non-1040A, < \$25K	0.88	1.30	1.17
\$25K < \$50K	0.53	0.90	0.95
\$50K < \$100K	0.72	1.05	1.16
\$100K and over	2.94	2.79	2.85
Sch. C, receipts < \$25K	4.39	5.85	4.21
Sch. C, receipts \$25K < \$100K	3.01	3.08	2.85
Sch. C, receipts \$100K and over	3.57	3.47	4.09
Corporations, by asset size:			
Under \$250K	0.84	0.78	1.04
\$250K < \$1M	2.47	2.18	2.76
\$1M < \$5M	7.11	6.05	6.64
\$5M < \$10M	15.83	14.89	14.08
\$10M < \$50M	22.49	19.79	19.88
\$50M < \$100M	24.69	22.04	21.29
\$100M < \$250M	30.77	27.92	27.57
\$250M and over	55.14	51.77	49.61